SUPREME COURT, U. S.

FEB 1 1974

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 1973

No. 73-1185

F. PAUL DUFFY and VIRGINIA H. DUFFY,
Petitioners

vs.

UNITED STATES OF AMERICA,
Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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vs.

UNITED STATES OF AMERICA,
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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The Petitioners, F. Paul Duffy and Virginia H. Duffy, respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding on November 16, 1973.

OPINIONS BELOW

The opinion of the Court of Appeals (Appendix p. 17) is reported at 473 F. 2d 840. The opinion of the District Court for the Southern District of Ohio (Appendix p. 30) is reported at 343 F. Supp. 4. The Court of Appeals reversed the judgment of the District Court, which found in favor of the Petitioners.

JURISDICTION

The judgment of the Court of Appeals (Appendix p. 15) was entered on November 16, 1973. The jurisdiction of this Court is invoked under 28 U.S.C.A. § 1254, (1).

QUESTION PRESENTED

Whether the grantors of a short term trust, revocable after ten years and thirty days, are taxable as the owners thereof, from its inception, under § 677 (a) (2) of the Internal Revenue Code, 26 U.S.C.A. 677 (a) (2), because on possible revocation, they may recover income over which they had no control, which has accrued during the ten year and thirty day period.

STATUTORY AND CONSTITUTIONAL PROVISIONS

The issues in this case arise directly out of § 677 (a) (2) of the Internal Revenue Code of 1954 (26 U.S.C.A. § 677). Indirectly involved, for interpretive purposes are §§ 673, 674 and 676 of the Internal Revenue Code of 1954 (26 U.S.C.A. §§ 673, 674 and 676). Each of the cited statutes contains a "General Rule" and relevant exception thereto. The General Rules are as follows:

> Sec. 677 (1954 Code). (a) GENERAL RULE — The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a nonadverse party, or both, may be —
>
> (1) distributed to the grantor;
> (2) held or accumulated for future distribution to the grantor; or * * *

Sec. 673 (1954 Code). (a) GENERAL RULE — The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

Sec. 674 (1954 Code). (a) GENERAL RULE — The grantor shall be treated as the owner of any portion of a trust in respect of which the beneficial enjoyment of the corpus or the income therefrom is subject to a power of disposition, exercisable by the grantor or a nonadverse party, or both, without the approval or consent of any adverse party.

Sec. 676 (1954 Code). (a) GENERAL RULE — The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both.

Each of the cited statutes, also contains an excepting clause, in identical language with that contained in § 677 which is as follows:

> This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under § 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

Relevant also, are the following Constitutional provisions:

Article I, § 1 of the Constitution of the United States: All legislative powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.

Amendment XVI to the Constitution of the United States: The Congress shall have power to lay and collect taxes on income from whatever source derived, without apportionment among the several states and without regard to any census or enumeration.

The following treasury regulation, explaining the excepting clause, is cited in the opinion of the court of appeals:

Treas. Reg. § 1.677 (a)-1 (e), (f) (1965):

(e) The last sentence of section 677 (a) provides an exception to the general rule when a discretionary right can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673 (a)—1 and 1.673 (b)—1. For example, if the ordinary income of a trust is payable to B for 10 years and then in the grantor's discretion income or corpus may be paid to B or to the grantor, the grantor is not treated as an owner with respect to ordinary income under section 677 during the first 10 years. He will be treated as an owner under section 677 after the expiration of the 10-year period unless the power is relinquished.

(f) However, if income is accumulated in any taxable year for future distribution to the grantor, section 677 (a) (2) treats the grantor as an owner for that taxable year. The exception set forth in the last sentence of section 677 (a) does not apply merely because the grantor must await the expiration of a period of time before he can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved. Thus, if income (in-

cluding capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor may be, distributed to the grantor, the grantor is treated as the owner of the trust from its inception. (emphasis added)

STATEMENT OF THE CASE

PRELIMINARY. During the tax years involved, 1963, 1964 and 1966, Petitioners did not include in their income tax returns, income received by a trust from the rental of real estate leased by the Trustee, the Provident Bank of Cincinnati, Ohio, to the Petitioner, Dr. F. Paul Duffy, for use in the practice of his profession as an orthopedic surgeon. Petitioner, Dr. F. Paul Duffy, deducted the rentals paid as an ordinary and necessary business expense.

Pursuant to an audit of Petitioners' joint income tax returns, the Internal Revenue Service took the position that, either the income of the trust should have been included in Petitioners' income for the years in question under § 677 (a) (2), or, in the alternative, the identical trust income was not an ordinary and necessary expense of doing business and therefore was not deductible under § 162 (a) (3) of the Internal Revenue Code. Deficiencies of tax and interest were therefore assessed. Petitioners paid the assessed deficiencies and thereupon filed claims for refunds. The District Director disallowed the claims for 1963, 1964 and 1966 but did not question the claim for 1965. Petitioners thereupon filed suit in the District Court. The District Court, upon motion for summary judgment, found that the trust income was not includible in Petitioners' income for the years in question and that the rent paid by the Petitioner, Dr. F. Paul Duffy, was deductible as an ordinary and necessary business expense, and awarded judgment for the Petitioners. (Appendix, p. 29)

The Court of Appeals reversed the District Court and found that the income of the trust should have been included in the Petitioners' income under § 677 (a) (2) of the Code. Having found for Respondent on the taxability of the income from the trust to the Petitioners, the Court of Appeals did not reach or determine the alternative issue as to rent deductibility under § 162 (a) (3) of the Code. The latter issue is therefore not involved on this motion for certiorari.

FACTS. Petitioners on July 31, 1962 jointly purchased the land and building at 155 West McMillan Street, Cincinnati, Ohio. On Februray 26, 1963, Petitioners as grantors and the Provident Bank of Cincinnati, Ohio, as Trustee, entered into a trust agreement. (Appendix p. 39) Under the terms of the trust, the Trustee is directed to establish a separate trust for each of the four children of the grantor and to accumulate the income for distribution to the children upon their attaining the age of 21 years. The only beneficiary to have attained the age of 21 years, during the ten years and thirty days in question, is James P. Duffy, who has been receiving income since May 30, 1966. The trust provides that ultimate distribution of all principal and income shall be made to the children when the youngest child shall have attained the age of twenty-five years. The youngest child was born on November 8, 1956 so that ultimate distribution of the trust would not be made before November 8, 1981.

The trust agreement includes a simple power to revoke.

Nowhere in the trust agreement is the Trustee, nor are the grantors, authorized or empowered either during the life of the trust, or upon its termination, whether after ten years and thirty days or in 1981, to distribute or accumulate income for future distribution to the grantors. The Trustee is given "complete custody and control of the trust property and all additions thereto, with power to

receive, hold, manage, convert, sell, assign, transfer, mortgage, pledge, lease, alter, exchange, invest, reinvest, and in any other way deal with the trust property as it, in its sole discretion, shall deem to be in the best interest of the trust estate." (Appendix, p. 42)

On February 26, 1963, Petitioners conveyed to the Provident Bank, as Trustee, the real estate in question, as improved by Petitioners for use as medical offices. The deed was absolute and unconditional. On February 26, 1963, the Provident Bank, as Trustee, leased the premises to Dr. Duffy for the original term of five years, beginning March 1, 1963, at an annual rental of $8,500.00. The term of the lease was subject to renewal for an additional five years and in each of the calendar years in question, Dr. Duffy paid the specified rental and it is stipulated in the record that the agreed rental is fair and reasonable.

The Provident Bank, as Trustee-Lessor, reported the rentals received during the years in question on U.S. Fiduciary Income Tax returns and claims depreciation on the building and improvements.

REASONS FOR GRANTING THE WRIT

The Court of Appeals has decided an important question of federal tax law which has not been, but should be settled by this Court. This circumstance brings the Petitioners squarely within the ambit of Rule 19 (b) of this Court, which establishes guidelines for the admission of cases on petition for Writ of certiorari. The case is primarily one of statutory construction.

The question presented is one of importance in the administration of the federal tax laws and is of broad, general interest to taxpayers, lawyers, accountants, banks and trust companies and others engaged in the field of tax planning.

Congress, in enacting the Internal Revenue Code of 1954, included § 673 thereof, and in so doing, validated the short term trust, by exempting a grantor from taxation as the owner of a trust in which he has a reversionary interest in either the corpus or income, if, as of the inception of the trust, the interest (either in corpus or income) will not or may not reasonably be expected to take effect in possession or enjoyment within ten years commencing with the date of the transfer of the trust.

Sections 674, 676 and 677 of the Code in their "general rules" spelled out therein, tax the grantor as the owner of a trust in which he retains "powers" over it, as distinguished from the retention of a "reversionary interest." These powers are: the power to control beneficial enjoyment (§ 674); the power to revoke (§ 676); and the power to distribute or accumulate income for future distribution for the benefit of the grantor (§ 677). It is this latter section of the Code which is directly involved in this case.

"In order that more severe tax consequences might not result from a power in a trust, than from a reversionary interest to take effect after the same period," Congress enacted identical excepting clauses as additions to §§ 674, 676 and 677, which "correlate" those sections with the short term trust rule established in § 673, 3 U.S. Cong. & Admin. News (1954), 4621 (P.P. 5008, 5009); S. Rep. No. 1622, 83d Congress 2d Sess. 367, 370, 371. As stated in U.S. Cong. & Admin. News (P.P. 5008, 5009) relating to § 674: "thus, under the exception, a power which may only affect the income for a period, commencing after ten years, will not subject the grantor to tax during the prior period." With regard to the excepting clause under § 677, it is stated (*Id.* P. 5012): "a limitation with respect to powers over income of a period after the expiration of a time specified in § 673, is provided, consistent with

the treatment in §§ 674 and 676." Similar language is used in the Committee Report on § 676 (*Id.* P. 5012).

The general purpose of Congress therefore, in enacting the excepting clauses to the sections dealing with the respective "powers" was to make short term trusts, provided for in § 673, available on the same basis tax-wise, as they were for trusts containing "reversionary interests."

The Internal Revenue Service by its Regulations, 1.677 (a)-1 (e) (f) (1965), supported by the Court of Appeals in its decision has construed the excepting clause to § 677 (a) (2), as excluding from the tax protection therein provided, income which accrues to the trust during the ten year period but which has not been received or beneficially enjoyed by the grantors during that period; in other words, control of income by the grantors or the lack of it is irrelevant to the issue of taxability. Under this interpretation of the statute, the grantor of a valid short term trust cannot avail himself of the statutory tax advantages attached to such trusts, without renouncing in advance, as of the inception of the trust, any claim to income which may accrue during the ten year period, over which he has no control and of which he cannot come into possession or beneficial enjoyment until after ten years. This accrued income, furthermore, is derived from a trust, of which the law treats the grantor as the owner, if he elects to exercise his power at the prescribed time. The interpretation placed upon the statute in question therefore, imposes more severe tax consequences on the grantor of a short term trust containing a "power" than upon such a trust containing a reversionary interest. This attempted distinction between a power and a reversionary interest, in short term trusts, is contrary to the plain intent of Congress as embodied in the excepting clause attached to the statutes in question.

The trust under consideration here, confers no power on either the grantors or the Trustee, over distribution or accumulation of income for future distribution to the grantors during the entire ten year and thirty day period of the trust, or upon its termination, no matter how terminated. The Trustee is expressly directed to accumulate for and distribute income to the ultimate beneficiaries, the children of the grantors, and no one else. "Since there is no power conferred by the trust agreement on the trustee to distribute income to the grantors, at any time, there can be no power in the trustee to accumulate income for future distribution to the grantors. If there should be any later delivery of the trust principal and income to the grantors by the trustee, it can only be after the exercise of the power of revocation in the trust agreement, which will terminate immediately as of that time all of the powers of the trustee. Such later delivery must therefore be pursuant to an equitable obligation of the trustee arising out of a resulting trust to the grantors upon revocation of the express trust. (*Schenerlein* v. *Schenerlein*, 29 O.Ops. 2d 65, 93 O.L. Abs. 94, 197 N.E. 2d 231)." If any income is ever received by the grantors, it will be solely by virute of the exercise by the grantors of their power of revocation pursuant to a valid short term trust.

Since there is no power of distribution or of accumulation for future distribution to the grantors in the trust instrument, there can be no constructive receipt of income by them which accrues during the ten year period. Nor can there be any constructive receipt of income accruing during the ten year period, as a result of the possible exercise by the grantors of a power to revoke which is not exercisable during that period. In this respect the Duffy trusts are clearly distinguishable from the only case

cited by the Court of Appeals in the opinion, *Humphrey* v. *United States*, reported in 245 F.Supp. 49 (D.C.Kansas. 1965). In the Humphrey case, the grantor was Trustee along with his father and brother; he also had the power under the trust instrument, during the ten year period of the trust to accumulate income for ultimate distribution to himself. This power which does not exist in the Duffy trust amounted to constructive receipt of income which accrued during the ten year period of the trust.

The position taken by the Respondent in this case, sustained by the Court of Appeals, and denied by the District Court, in taxing income from a valid short term trust, which has not been received or brought under the control of the grantor runs counter to the position taken by the Internal Revenue Service, as to constructive receipt of income generally. Under the Income Tax Law, the Commissioner has held, generally, that there is no constructive receipt unless the income is credited without restriction and made available to the taxpayer, to the extent that it may be drawn upon and brought immediately under his control and disposition. (CCH 1974, ¶ 2834.01: Constructive Receipt of Income.)

The Congressional intent in the excepting clause is to relate taxability of a short term trust, not to income which merely accrues during the ten year period, but to one or the other of two circumstances: (1) failure of the grantor to relinquish his power after ten years, or (2) an existing power in the trust instrument, concurrent with and exercisable during the ten year period, to distribute or accumulate income for future distribution for the benefit of the grantor. The power in question in this case is a simple power to revoke, which is not exercisable within the ten year period. Congress has in effect given the grantor of a valid short term trust, an option after ten years, to relin-

quish the power free of taxability as the owner, or, on the other hand to exercise his power, recover the principal and income and, at that time to become taxable as the owner of the trust. The interpretation of the statute adopted by the Internal Revenue Service and the Court of Appeals taxes the grantor as the owner as of the inception of the trust and effectively deprives the grantor of his option.

It is, of course, unnecessary to cite to this Court any authorities to the effect that tax statutes, if there were any doubt as to their interpretation, must be construed most strongly against the Government and in favor of the taxpayer. The interpretation of the Respondent, adopted by the Court of Appeals, amounts to administrative and judicial legislation in contravention of Article 1, § 1 of the United States Constitution and of Amendment XVI thereto which vest legislative powers including the enactment of tax statutes, exclusively in the Congress.

The opinion of the Court of Appeals is palpably wrong and has generated a dense fog out of which emanates the judicial pronouncement that the grantor of a valid short term trust cannot, upon revocation, recover income which has accrued during the ten year period, from a trust, of which the statute treats him as the owner, because in the language of the Court, it was the Congressional intent, in enacting the excepting clause to § 677 (a) (2), only "to insure that a power over the trust income received after ten years would not of itself, taint the trust income received during the ten year period." The language of the opinion can do nothing but befuddle the harassed taxpayer, as to his rights under the law. Among other things, the opinion fails to distinguish between income which merely accrues during the ten year period and income which is received and beneficially enjoyed by the grantor during that time.

CONCLUSION

It is respectfully submitted that the Respondent and the Court of Appeals have ignored the Congressional intent in the enactment of the statutes in question; that the issues in this case should be clarified and settled by the Court of last resort, and that a writ of certiorari should issue to review the judgment and opinion of the Court of Appeals for the Sixth Circuit.

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APPENDIX

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

No. 72-2050

F. PAUL DUFFY AND VIRGINIA H. DUFFY,
Plaintiffs-Appellees,

vs.

UNITED STATES OF AMERICA,
Defendant-Appellant.

Before: McCREE and KENT, Circuit Judges, and CECIL, Senior Judge.

JUDGMENT

(Filed November 16, 1973.)

APPEAL from the United States District Court for the Southern District of Ohio.

THIS CAUSE came on to be heard on the record from the United States District Court for the Southern District of Ohio and was argued by counsel.

ON CONSIDERATION WHEREOF, It is now here ordered and adjudged by this Court that the judgment of the said District Court in this cause be and the same is hereby reversed and the case is remanded for further proceedings.

It is further ordered that Defendant-Appellant recover from Plaintiffs-Appellees, the costs on appeal, as itemized below, and that execution therefor issue out of said District Court.

ENTERED BY ORDER OF THE COURT

/s/ JAMES A. HIGGINS
Clerk

Issued as Mandate:

COSTS:

Filing fee .....$
Printing $
Total $

A True Copy

Attest:

JAMES A. HIGGINS, Clerk

No. 72-2050

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

F. PAUL DUFFY AND VIRGINIA H. DUFFY,
Plaintiffs-Appellees,

vs.

UNITED STATES OF AMERICA,
Defendant-Appellant.

On Appeal from the United States District Court for the Southern District of Ohio.

Decided and Filed November 16, 1973.

Before: McCREE and KENT,* Circuit Judges, and CECIL, Senior Circuit Judge.

McCREE, Circuit Judge. The government appeals from a judgment for taxpayers in an action to recover income taxes paid upon assessment of a deficiency by the Internal Revenue Service for the calendar years 1963 to 1966. The facts were stipulated and the case was submitted on cross-motions for summary judgment. The district court's opinion is reported at 343 F. Supp. 4 (S.D. Ohio 1972).

The taxpayers, F. Paul Duffy, a physician, and his wife, Virginia H. Duffy, purchased improved real estate in Cincinnati, Ohio on July 31, 1962, for use by Dr. Duffy in his

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* Judge Kent died on May 27, 1973 and did not participate in this decision.

medical practice. Shortly thereafter, on February 26, 1963, the Duffys executed a trust agreement [1] pursuant to which they conveyed this property to the Provident Bank as trustee. On the same day, the Duffys and the bank executed a five year lease-back agreement, renewable for an additional five years, in which Dr. Duffy agreed to pay an annual rent of $8,650, an amount stipulated as reasonable.

The trust agreement created four trusts, one for the benefit of each of their children: James, born on May 30, 1945; Timothy, born on November 23, 1948; Julia, born on August 7, 1951; and Eileen, born on November 8, 1956. These trusts were made irrevocable for 10 years and 30 days and amendable and revocable thereafter. The trust instrument provides that a beneficiary, while a minor, may receive, if necessary in the sole discretion of the trustee, his share of the trust principal or the income generated by it for his education, maintenance or welfare. Income not distributed for these purposes is to be accumulated by the trustee. When each child reaches his majority, his share of the accumulated and unexpended trust income is to be made part of the trust corpus.[2] However, his

[1] The Trust in this case is similar to a "Clifford" trust, a designation derived from the United States Supreme Court's decision in *Helvering* v. *Clifford*, 309 U.S. 331 (1940). In that case, the grantor acted as trustee of a trust, created for the benefit of his wife. The present sections of the Internal Revenue Code, 26 U.S.C. §§ 671-78 (1967) were enacted to overcome the problems and to close the loopholes in the 1939 Code. A basic concern addressed by both the old and new trust taxation provisions is the ability of one taxable unit, for example, a family, to multiply itself into several taxable units by the creation of trusts.

[2] The district court apparently misunderstood the provisions of the trust instrument. Thus, the court stated, in distinguishing *Humphrey* v. *C.I.R.*, 39 T.C. 199 (1962), that "[t]he clear language and intent of section 2 of the trust agreement is for the *trustee* to accumulate the income of the trust for the benefit of the *beneficiaries* and to distribute such accumuated income to the *beneficiaries* upon their reaching a certain age." *Duffy* v. *United States*, 343 F. Supp. 4, 8 (1972). If

share of the trust income accruing thereafter must be distributed to him. Moreover, unless the trust is revoked or amended as it may be after 10 years and 30 days, the principal and the income accumulated during the minority of each child will be distributed among the beneficiaries when the youngest becomes 25. No beneficiary has ever received any income during his minority. However, on May 30, 1966, James, the eldest Duffy child, became 21 and began receiving the income thereafter accruing to his trust.

During the tax years 1963 through 1966, taxpayers did not include in their income the taxable income received by the trust from the rental of the property to Dr. Duffy. Moreover, during the same period of time, taxpayers deducted as an ordinary and necessary business expense the rent paid by Dr. Duffy to the trust.

Pursuant to an audit of taxpayers' joint returns for the tax years 1963, 1964, 1965, and 1966, the Internal Revenue Service (IRS) concluded that either the taxable income of the trust should have been included in taxpayers' income for these years or, alternatively, that the rent paid by Dr. Duffy, less the depreciation allowance for the building was not an ordinary and necessary business expense. Deficiencies of tax and interest were therefore assessed.

After paying the assessed deficiencies, taxpayers filed a claim for refund for each year involved. The District Director disallowed their claims for 1963, 1964 and 1966 but, possibly because of an oversight, allowed their claim for 1965.

Taxpayers then filed a suit in United States District Court. The district court found that the taxable trust income for the years in question was not includible in tax-

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the trust instrument had provided that all accumulated income must be distributed to the beneficiaries, the trust income would not have been includible in the taxpayers' income.

payers' income and that the rent paid by Dr. Duffy was an ordinary and necessary business expense. The court, therefore, granted the taxpayers recovery of assessed income taxes and interest for 1963, 1964 and 1966, in the amount of $14,965.25 plus accumulated interest. *Duffy* v. *United States*, 343 F. Supp. 4 (S.D. Ohio 1972).

In this appeal the government argues that either the district court erred in holding that the bank is an "adverse party" as defined by section 672(a) of the Internal Revenue Code, 26 U.S.C. § 672(a) (1967) and that therefore the Duffys should have included in their income the taxable trust income under section 677(a)(2) of the Internal Revenue Code, 26 U.S.C. § 677(a)(2) (1967) or that the district court erred in holding that the Duffys were entitled to deduct the rent paid for Dr. Duffy's office as an ordinary and necessary business expense under section 162 of the Code, 26 U.S.C. 162 (1967). Taxpayers argue, however, that because the trust comes within the excepting clause of section 677, there is no need to consider whether the bank is an "adverse party" and that the district court was correct in holding that the rent payments were ordinary and necessary business expenses.

We hold that the taxable income of the trust should have been included in the taxpayers' income under section 677(a)(2) of the Internal Revenue Code. Accordingly, we do not reach the government's alternative assignment of error.

Section 677(a)(2) of the Internal Revenue Code, Income for benefit of grantor, 26 U.S.C. § 677(a)(2) (1967), provides in relevant part, that:

> (a) General rule. The grantor shall be treated as the owner of any portion of a trust . . . whose income without the approval or consent of any adverse party

> is, or, in the discretion of the grantor or a nonadverse party, or both, may be . . .
>
> (2) held or accumulated for future distribution to the grantor . . . .

This provision is followed immediately by an "excepting" clause which provides that

> [t]his subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

This section is dispositive of the issues in this case: first, whether the taxpayers are exempt from the application of the general rule of the section by virtue of the excepting clause, and second, if the taxpayers do not come within the excepting clause, whether the institutional trustee is an "adverse party" within the meaning of the general rule. We hold that the taxpayers cannot avail themselves of the excepting clause and that the Provident Bank is not an adverse party.

To come within the excepting clause, taxpayers argue, they need only show that they had no power during the initial ten years of the trusts to control the beneficial enjoyment of the trust income. If during this period they could not control the disposition of trust income, they argue that the taxable trust income should be taxed to the trust, not to them. Taxpayers attempt to bolster this argument by referring to section 673 of the Code, Reversionary interests, 26 U.S.C. § 673 (1967), which provides in relevant part:

> (a) **General Rule.**—The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income therefrom if, as of the inception of that portion of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of the transfer of that portion of the trust.

We, however, interpret the reference to section 673 in the excepting clause to section 677 as referring not merely to the ten year period of time during which the grantor of a trust may not have an existing exercisable power to affect the distribution of trust income but also to the income received by the trust during that ten year period. Thus, we do not agree with taxpayers that a grantor of a trust is entitled to the benefits of the excepting clause of section 677 as long as he may not during the initial ten year period of the trust affect the disposition of the trust income even though after ten years and a day the grantor may cause the accumulated trust income to be distributed to himself.

Nor does the last part of the excepting clause, "but the grantor may be treated as the owner after the expiration of the [ten year] period unless the power is relinquished," compel a contrary interpretation. That part of the excepting clause provides only that subsection 677 (a) does not apply to powers the exercise of which can affect the beneficial enjoyment of trust income received only after ten years. This provision was intended to insure that a power over trust income received after the initial ten year period would not itself taint the trust income received during the ten year period. It was not intended to exempt a grantor from taxation on trust income received during the ten year period if after the expiration of that period the grantor

has the power to dispose of that very income. S. Rep. No. 1622, 83d Cong., 2d Sess. 371; 3 United States Code Cong. & Admin. News 4621, 5012 (1954).

Our interpretation of the excepting clause of section 677 is supported by the considered interpretation of the agencies charged with administering the tax laws. Thus, Treas. Reg. § 1.677(a)-1(e), (f) (1965) explains the excepting clause as follows:

> (e) The last sentence of section 677(a) provides an exception to the general rule when a discretionary right can only affect the beneficial enjoyment of the income of a trust received after a period of time which is such that a grantor would not be treated as an owner under section 673 if the power were a reversionary interest. See §§ 1.673(a)—1 and 1.673(b)—1. For example, if the ordinary income of a trust is payable to B for 10 years and then in the grantor's discretion income or corpus may be paid to B or to the grantor, the grantor is not treated as an owner with respect to ordinary income under section 677 during the first 10 years. He will be treated as an owner under section 677 after the expiration of the 10-year period unless the power is relinquished.
>
> (f) However, if income is accumulated in any taxable year for future distribution to the grantor, section 677(a)(2) treats the grantor as an owner for that taxable year. *The exception set forth in the last sentence of section 677(a) does not apply merely because the grantor must await the expiration of a period of time before he can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as an owner under section 673 if a reversionary interest were involved.* Thus, if income (including capital gains) of a trust is to be accumulated for 10 years and then will be, or at the discretion of the grantor may be, distributed to the grantor, the

grantor is treated as the owner of the trust from its inception. (emphasis added) [3]

Moreover, in 1957, the Internal Revenue Service issued a ruling in which it adopted the same interpretation of the

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[3] The Treasury Regulation also provides the following examples to illustrate the application of Section 677(a):

Example (1). G creates an irrevocable trust which provides that the ordinary income is to be payable to himself for life and that on his death the corpus shall be distributed to a designated charity. Except for the right to receive income, G retains no right or power which would cause him to be treated as an owner under sections 671 through 677. Under the applicable local law capital gains must be applied to corpus. During the taxable year 1955 the trust has the following items of gross income and deductions:

Dividends	$5,000
Capital gain	1,000
Expenses allocable to income	200
Expenses allocable to corpus	100

Since G has a right to receive income he is treated as an owner of a portion of the trust under section 677. Accordingly, he should include the $5,000 of dividends, $200 income expense, and $100 corpus expense in the computation of his taxable income for 1955. He should not include the $1,000 capital gain since that is not attributable to the portion of the trust that he owns. See § 1.671-3. The tax consequences of the capital gain are governed by the provisions of [subparts A, B, C, and D (section 641 and following), part I, subchapter J, chapter 1 of the Code]. Had the trust sustained a capital loss in any amount the loss would likewise not be included in the computation of G's taxable income, but would also be governed by the provisions of [such subparts].

Example (2). G creates a trust whose ordinary income is payable to his adult son. Ten years from the date of transfer or on the death of his son, whichever is earlier, corpus is to revert to G. In addition, G retains a discretionary right to receive $5,000 of ordinary income each year. (Absent the exercise of this right all the ordinary income is to be distributed to his son.) G retains no other right or power which would cause him to be treated as an owner under subpart E [(section 671 and following), of such part I]. Under the terms of the trust instrument and applicable local law capital gains must be applied to corpus. During the taxable year 1955 the trust had the following items of income and deductions:

excepting clause of section 677 under the following circumstances. The grantor created a trust, irrevocable for 12 years, in which an independent trustee was empowered to expend any and all of the trust principal and income for the education, maintenance and welfare of the beneficiary, the grantor's child. Any income not expended or distributed could be accumulated or invested by the trustee at his discretion. At the expiration of the trust, the trustee was required to return to the grantor any principal not expended or distributed and to the grantor or the beneficiary

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Dividends	$10,000
Capital gain	2,000
Expenses allocable to income	400
Expenses allocable to corpus	200

Since the capital gain is held or accumulated for future distributions to G, he is treated under section 677(a)(2) as an owner of a portion of the trust to which the gain is attributable. Therefore, he must include the capital gain in the computation of his taxable income. (Had the trust sustained a capital loss in any amount, G would likewise include that loss in the computation of his taxable income.) In addition because of G's discretionary right (whether exercised or not) he is treated as the owner of a portion of the trust which will permit a distribution of income to him of $5,000. Accordingly, G includes dividends of $5,208.33 and income expenses of $208.33 in computing his taxable income, determined in the following manner:

Total dividends	$10,000.00
Less: Expenses allocable to income	400.00
Distributable income of the trust	9,600.00
Portion of dividends attributable to G (5,000/9,600 X $10,000)	5,208.33
Portion of income expenses attributable to G (5,000/9,600 X $400)	208.33
Amount of income subject to discretionary right	5,000.00

In accordance with [paragraph (c) of § 1.671-3], G also takes into account $104.17 (5,000/9,600 X $200) of corpus expenses in computing his tax liability. The portion of the dividends and expenses of the trust not attributable to G are governed by the provisions of [subparts A through D].

any accumulations of income. In that case the grantor-taxpayer also argued that the trust provisions fell within the excepting clause of section 677. However, the IRS found that because the trustee's power over current income, that is, income accruing to the trust during its 12 year life, might in fact result in the accumulation of income not for the benefit of the beneficiary but for the benefit of the grantor, the grantor was taxable for trust income received during the 12 year period. The IRS expressed its opinion in the following rule: "where the trustee has a power to withhold distribution of trust income from the beneficiary and accumulate the amount so withheld for ultimate distribution to the grantor or to his estate, the grantor will be treated as the owner of the trust under the provisions of section 677 (a) (2) of the Internal Revenue Code of 1954, and the income therefrom will be taxable to him." Rev. Rul. 363, 1957-2 Cum. Bull. 326, 329.

This Revenue Ruling was relied upon by the court in *Humphrey* v. *United States*, 245 F. Supp. 49 (D. Kan. 1965), where the court reached the result we reach here in considering the taxability of the grantor of a trust having provisions similar to the trust in this case.[4] There, the grantor-taxpayer created a trust for the benefit of his children, irrevocable for 15 years, in which the trust corpus consisted of the grantor's one-third interest in a partnership. The trustee, the grantor, his brother and his father, were authorized to invest or accumulate the earnings of the trust. The trust instrument provided that after the expiration of the trust, all trust property remaining and unexpended would at the option of the grantor revert to

[4] This case is substantially the same as *Humphrey* v. *C.I.R.*, note 2, *supra*, discussed by the district court, involving identical trusts created by one Humphrey brother in the one case, and the other Humphrey brother in the other.

him. The court found that because the trustees were empowered to accumulate trust income which might, after 15 years, be distributed to the grantor, the grantor should be treated as the owner of the trust from its inception.

We believe that the Code, the regulations and rulings promulgated thereunder, and the court's decision in *Humphrey, supra,* require that when a trustee has the power to accumulate trust income during the initial ten years of the trust and this income may thereafter be received by the grantor, the grantor may not avail himself of the excepting clause of section 677.

Accordingly, the taxpayers in this case are subject to the general rule of section 677 (a) unless the trustee is an adverse party within the meaning of section 672 (a) of the Code, 26 U.S.C. § 672 (a) (1967). Section 672, Definitions and rules, defines an adverse party as "any person having a substantial beneficial interest in the trust which would be adversely affected by the exercise or nonexercise of the power which he possesses respecting the trust . . ." Section 672 (a), on its face, defines an adverse party as a person having a beneficial interest in the trust, that is, a beneficiary of the trust. In this case, the Provident Bank is not a beneficiary and is not, therefore, an adverse party. This conclusion is reinforced by the Treasury Department's explanation of this term:

> Under section 672 (a) an adverse party is defined as any person having a substantial beneficial interest in a trust which would be adversely affected by the exercise or nonexercise of a power which he possesses respecting the trust. *A trustee is not an adverse party merely because of his interest as trustee.* A person having a general power of appointment over the trust property is deemed to have a beneficial interest in the trust. An interest is a substantial interest if its value in relation

> to the total value of the property subject to the power is not insignificant. (emphasis added).

Treas. Reg. 1.672 (a) – (1) (1956).

We, therefore, reject taxpayers' argument that a trustee who is independent of the grantor of a trust may properly be considered an adverse party because he is required by law to act solely in the interest of the beneficiaries of the trust. Both the language of the statute requiring an adverse party to have a beneficial interest in the trust and the Treasury Department's reasonable interpretation of this definition that a trustee, *qua* trustee, is not an adverse party preclude placing such a gloss on the statute.

Therefore, because the Provident Bank, as trustee, is not an adverse party and because under the terms of the trust it may accumulate trust income during the initial ten years of the trust for possible future distribution to the grantors without the consent of the beneficiaries, we determine that the taxable trust income is properly includible in taxpayers' income.

Reversed and remanded for proceedings not inconsistent with this opinion.

IN THE
UNITED STATES DISTRICT COURT FOR THE
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

CIVIL ACTION NO. 6946

F. PAUL DUFFY AND VIRGINIA H. DUFFY,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

JUDGMENT

(Filed August 1, 1972)

This action came on for hearing before the Court, Honorable David S. Porter, presiding, and the issues having been duly heard, and an opinion having been duly rendered,

IT IS ORDERED AND ADJUDGED

that the plaintiffs, F. Paul Duffy and Virginia H. Duffy, recover of the defendant, the United States of America, the sum of $14,965.25, with interest thereon at the rate of 6% from the time or times of payments by the plaintiffs and costs.

Dated at Cincinnati, Ohio, this 31st day of July, 1972.

Approved as to form:

/s/ DAVID S. PORTER,
UNITED STATES DISTRICT JUDGE

/s/ BYRON E. TRAPP,
United States Attorney.

/s/ FRANK J. RICHTER,
Attorney for Plaintiffs

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
WESTERN DIVISION

NO. 6946

F. PAUL DUFFY AND VIRGINIA H. DUFFY,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

OPINION AND ORDER

(Filed April 12, 1972)

This is a tax refund case involving a Clifford trust (one with a lease-back). Two questions are presented. One, under the facts stipulated, did the taxpayer-lessee properly claim the rent as a deduction? Two, is the income of the trust taxable to the grantors?

Taxpayers purchased the land and building at 155 West McMillan Street, Cincinnati, Ohio, on July 31, 1962. On February 26, 1963, they executed a trust agreement, a copy of which is set out in the appendix. The trust agreement was with The Provident Bank and conveyed the property to the trustee in trust for the benefit of their four children. The trust was irrevocable for a period of ten years and thirty days. The Bank was sole trustee and was given complete powers. The duties of the trustee were spelled out and included the duty "to accumulate the income from each of the trusts for the beneficiaries thereof, unless expenditures of said income shall, in the sole discretion of the trustee, become necessary for the education, maintenance or welfare of such beneficiaries." The trust was amendable by joint action of the grantors upon expiration of the period of ten years and thirty days (*id.* ¶ 7).

The same day the trust agreement was executed the Bank leased the building back to plaintiff, F. Paul Duffy, a doctor, for an office. He claimed the lease payments as business deductions under 26 U.S.C. § 162. This was disallowed.

Under 26 U.S.C. § 162 (a) (3) deductions are allowed for all ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including rentals or other payments required to be made as a condition to the continued use or possession, for the purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title, or in which he has no equity.

As noted, it has been stipulated that the taxpayer, Dr. Duffy, uses the leased building for his professional use. However, the government contends the expenses claimed as a deduction are not "necessary."

The two major cases involving similar facts are *Skemp* v. *C.I.R.*, 168 F. 2d 598 (7 Cir., 1948) and *Van Zandt* v. *C.I.R.*, 40 T.C. 824 (1963). *Van Zandt* concerned a taxpayer who also owned a building which was used for his medical practice. He created two ten-year trusts for the benefit of his children, *naming himself as trustee*. He then conveyed the property by deed to the trustee, and as trustee leased the property back to himself. In that case it was held that there was no independent trustee. The grantor himself was the trustee. "For this reason and no other the petitioner has failed to bring himself within the ambit of those three decisions. [*Skemp, supra; Brown* v. *C.I.R.*, 180 F. 2d 926 (3 Cir., 1950); and *Felix* v. *C.I.R.*, 21 T.C. 794 (1954)]." *Van Zandt* v. *C.I.R., supra,* at 830.

Van Zandt also held that where a sale and lease-back does not serve a utilitarian purpose, but is in realty a camou-

flaged assignment of income, the expenses are not considered "ordinary and necessary."

Skemp, supra, has a fact pattern very similar to *Brown* and *Felix*. In *Skemp* the taxpayer was a physician who owned a two-storey building in which he conducted his medical practice. He created a trust for the benefit of his wife and children by conveying the building to the La-Crosse Trust Company as sole trustee. The trust was made irrevocable for twenty years duration unless the settlor and his wife were to die, in which case the trust would terminate. The taxpayer retained no significant control over the trust but did reserve the right to rent the building. Thereafter the taxpayer leased the building for his medical practice from the trust company. He then deducted the lease payment as a business expense.

The Court held in *Skemp* that unless a violation of the fiduciary duty can be imputed to the trustee, the taxpayer had a legal obligation to pay the rental. The trustee was duty bound to exact rent from the taxpayer and the taxpayer was duty bound to pay it. The Court held that this arrangement creates the same situation as if the taxpayer has rented a place to practice wholly apart from the trust property. In *Skemp* it was found that the taxpayer had irrevocably divested himself of all title and right to the property and could only occupy it upon the payment of rent, thus reflecting the change in the taxpayer's economic status. Thus, the taxpayer was allowed the deduction.

Oakes v. *C.I.R.*, 44 T.C. 524 (1965) recognized a line of demarcation between *Van Zandt* and *Skemp, Brown* and *Felix*. The *Oakes* case involved facts similar to *Skemp* where the phyisian created a trust for his children. Certain land and a building owned by the taxpayer were conveyed to the trustee, a bank. Then the taxpayer leased back the

building and subsequently deducted the rental payments as business expenses under § 162 (a).

Oakes stated that while the line of demarcation might be thin between the *Skemp, Brown* and *Felix* cases on one side and *Van Zandt* on the other, a difference nevertheless exists. One of the pivotal factors is the *actual independence* of the trustee. In *Van Zandt* the trustee was the grantor (or taxpayer) himself, but in *Oakes*, like *Skemp, Brown* and *Felix*, the control and ownership passed from the grantor to a bank as an independent trustee.

Oakes went on to hold that where a grantor gives business property to a valid irrevocable trust over which he retains no control and then leases it back, it is not necessary to inquire as to whether there was a business reason for making the gift. There is none. Under such circumstances, the test of business necessity should be made by viewing the situation as it exists after the gift is made.

In the instant case the joint stipulation of facts which contains the trust agreement shows that there was (1) an irrevocable trust for ten years and thirty days; (2) an independent trustee as sole trustee with complete powers; (3) a valid deed conveying the property to the trustee; (4) a written lease-back arrangement; and (5) no retention by the grantor of any significant control over or interest in the trust during the taxable years we are here concerned with.

We conclude that the instant case is like the *Skemp* case and therefore controlled by it. That does not end the discussion, however, because the United States has found the taxpayers to be the owners of the property and, in the alternative to disallowing the rent as a deduction, has treated such rent as income to the taxpayers.

We must therefore determine whether the grantors are the owners of the corpus of the trust under 26 U.S.C. § 676 and/or 677. Section 676 (a) provides:

"The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under any other provision of this part, where at any time the power to revest in the grantor title to such portion is exercisable by the grantor or a non-adverse party, or both."

Section 677 reads in part:

"The grantor shall be treated as the owner of any portion of a trust, whether or not he is treated as such owner under section 674, whose income without the approval or consent of any adverse party is, or, in the discretion of the grantor or a non-adverse party or both, may be — (2) held or accumulated for future distribution in the grantor. . . ." 26 U.S.C. § 677.

Section 676 (b) provides:

"Power affecting beneficial enjoyment only after expiration of ten-year period. — Subsection (a) shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that a grantor would not be treated as the owner under section 673 if the power were a reversionary interest. But the grantor may be treated as the owner after the expiration of such period unless the power is relinquished." 26 U.S.C. § 676 (b).

Section 677 (a) provides:

"This subsection shall not only apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished." 26 U.S.C. § 677 (a).

Section 673 states:

> "The grantor shall be treated as the owner of any portion of a trust in which he has a reversionary interest in either the corpus or the income if, as of the inception . . . of the trust, the interest will or may reasonably be expected to take effect in possession or enjoyment within 10 years commencing with the date of transfer."

Under these sections a grantor will be taxed on the income of a trust as the owner if he retains significant control over the trust or a power to revest the trust in himself, unless the control or power is not exercisable within a ten-year period. *Skemp, supra.*

These sections of the Internal Revenue Act were passed (and the present controversy arose) after the decision of the Court in *Helvering* v. *Clifford*, 309 U.S. 331 (1940). In *Clifford* the grantor named himself the trustee of certain securities for five years and was to pay to his wife the income from that trust. The grantor also retained the right to accumulate the income and, with a few exceptions, had complete control over the fund. Under these circumstances the grantor was considered to be the owner of the trust and the income of the trust was taxed to him.

> "The short duration of the trust, the fact that the wife was the beneficiary, and the retention of control over the corpus by the respondent all lead irresistably to the conclusion that respondent continued to be the owner . . . ." *Clifford, supra,* at 335.
>
> "Since the income remains in the family and the husband retains control . . . he has rather complete assurance that the trust will not effect any substantial change in his economic position." *Clifford, supra,* at 335.
>
> "For as a result of the terms of the trust and the intimacy of the familial relationship, respondent has

> retained the substance of full enjoyment of all rights which previously he had in the property." *Clifford, supra,* at 336.

In the instant case taxpayers' trust was irrevocable for ten years and thirty days and falls within the exception to §§ 676 and 677, unless the taxpayers retained sufficient interest in or control over the trust during the initial ten-year period so as to require that they be treated as the owners for tax purposes.

The United States relies on *Humphrey* v. *C.I.R.,* 39 T.C. 199 (1962). That was a case where the taxpayer created a trust for the benefit of his children. It was to terminate in 15 years. Taxpayer was also the trustee along with his brother and father. Hence, none of the trustees was adverse. There was no limitation on the extent to which they could accumulate income.

The taxpayer in *Humphrey* alleged, as does the taxpayer here, that he came within the exception of §§ 676 and 677 concerning trusts for period over ten years. The Court disagreed, relying on the following regulation:

> "The exception set forth in 677 (a) (and 676) does not apply merely because the grantor must await the expiration of a period of time before he can receive or exercise discretion over previously accumulated income of the trust, even though the period is such that the grantor would not be treated as owner under 673 if a reversionary interest were involved. Thus, if income of a trust is to be accumulated for ten years and then will be, or at the discretion of the grantor may be, distributed to the grantor, the grantor is treated as the owner of the trust from its inception." 1.6777 (a)-1-Income Tax Regs., 1961, Vol. I.

The government claims that section 2 of the trust agreement allows the taxpayer to accumulate income from the

trust and then at his discretion distribute it to himself after the ten-year and thirty day period. We disagree.

We conclude the *Humphrey* case is distinguishable from the instant case. In the instant case neither taxpayer is a trustee, as he was in *Humphrey*. The taxpayers here have given complete interest and control of the trust to an independent trustee, the bank. The clear language and intent of section 2 of the trust agreement is for the *trustee* to accumulate the income of the trust for the benefit of the *beneficiaries* and to distribute such accumulated income to the *beneficiaries* upon their reaching a certain age. The bank has no "unfettered discretion" to accumulate for taxpayers.

There is no conflict of interest as there was in *Humphrey*. In the *Humphrey* case the taxpayer, being the trustee, had the power to accumulate the income of the trust which eventually might be recaptured by the taxpayer when the trust terminated.

In the instant case, unless we impute a violation of fiduciary duty to the trustee, there is no such conflict. The trustee is duty-bound to accumulate the income of the trust *for the benefit of the beneficiaries* and to distribute it to them or to use it for their welfare, as he deems best. The trustee bank is under no control of the original grantor (taxpayer), and its only interest lies in administering the trust property for the best interests of the beneficiaries.

Next, we must say we are surprised at the government's argument that the taxpayers have retained equity in the trust property because the agreement provides it is amendable after ten years and thirty days (¶ 7).

Of course, there is "equity" in the legal sense, but if recovery of the trust property after the ten-year exception makes the income of the trust taxable to the grantor, the

plain language of the exception would be rendered meaningless.

In this connection, if the grantors had stated affirmatively that any accumulated income was to be for the express use of the beneficiaries during the trust and upon its termination and if they had disavowed any interest in such income there would be no question but that the trust falls within the exceptions to §§ 676 and 677. We hold that even though there is some possibility of recovery of the accumulated income, that does not make the income of the trust taxable to the grantors where there is an independent trustee with complete powers and a duty to accumulate income for the benefit of the beneficiaries and the revesting of the interest in the grantor is only a mere possibility.

Before concluding we note that it is settled that the taxpayer may act in a manner which will minimize his taxes. The purpose a settlor had in establishing a trust is irrelevant on the question as to whether income from the trust is taxable to the settlor. *Helvering* v. *Achelis*, 112 F. 2d 929 (9 Cir., 1940).

To recapitulate, we conclude that the taxpayers were not the owners of the trust under 26 U.S.C. §§ 676 and/or 677 and the income of the trust is not taxable to them. We also conclude that the taxpayer to whom the property was leased back as a medical office properly deducted the rent as a business expense. The parties' stipulation (¶ 23) provides that the exact refund to the plaintiffs as a result of this action together with interest according to law will be ascertained 60 days after the court files its opinion. It goes on to say that if they cannot agree, the matter will be submitted to the Court. Pursuant to this an appropriate order should be submitted for approval.

/s/ DAVID S. PORTER
United States District Judge

APPENDIX

TRUST AGREEMENT

This Agreement and Declaration of Trust, dated this 26th day of February, 1963, by and between F. PAUL DUFFY and VIRGINIA H. DUFFY, of Cincinnati, Ohio, hereinafter called the Grantors and THE PROVIDENT BANK of Cincinnati, Ohio, hereinafter called the Trustee,

WITNESSETH:

The Grantors have this day conveyed to the Trustee by deed recorded in Deed Book ——, page 619 of the Records of Deeds in the Office of the Recorder of Hamilton County, Ohio, the following described property, to-wit:

> Building known, numbered and designated as No. 155 West McMillan Street, Cincinnati, Ohio on the following described parcel of ground:
>
> Situate in the City of Cincinnati, County of Hamilton, State of Ohio, and in Section 13, Township 3, Fractional Range 2, Miami Purchase, and being a part of Lots Nos. 1 and 2 of Sarah Ammen's Estate Subdivision as recorded in Plat Book 1, page 127 of the Plat Records of Hamilton County, Ohio and beginning at a point in the South side of McMillan Street 100 feet West of the center line of an abandoned road 16½ feet wide, which road lies immediately adjoining on the East line of Lot No. 1 of Sarah Ammen's Estate; thence South, parallel with the East line of said Lot No. 1, 147 feet, more or less, to a point 100 feet North of Lyon Street; thence West, parallel with the South line of McMillan Street 55.07 feet to a point, the Southeast corner of Henry Moellering's lot; thence North, parallel with the East line of said Lot No. 1, and along the East line of said Moellering's lot, 147.69 feet to a point in the south line of McMillan Street; thence East, along the South line of McMillan Street, 55.07 feet to the place of beginning.

to have and to hold until the Trustee and its successors, including any corporation, association or other form of business organization into which it may be converted or merged or to which it may transfer substantially all of its assets and good will. IN TRUST, HOWEVER, for the following uses and purposes and subject to all the terms and conditions hereof:

1. To establish a separate trust therein in equal shares for each child of the Grantors now living, to-wit: James Paul Duffy, born May 30, 1945, Timothy Michael Duffy, born November 23, 1948, Julia Marie Duffy, born August 7, 1951, and Eileen Duffy, born November 8, 1956, or for each child hereafter to be born.

2. To accumulate the income from each of the trusts for the beneficiaries thereof, unless expenditures of said income shall, in the sole discretion of the Trustee, become necessary for the education, maintenance or welfare of such beneficiaries. At the time any such beneficiary shall have attained the age of 21 years, any accumulated and unexpended income shall then be added to the principal of the trust established on behalf of such beneficiary; and thereafter, all of the income of such trust shall be distributed to such beneficiary.

3. The Trustee may also, from time to time, pay out of the principal of the trusts to or for the benefit of any beneficiary thereof, such amounts as the Trustee, in its sole discretion, may determine to be necessary for such beneficiary's education, maintenance or welfare, provided however, that if any such payments out of principal are made, such beneficiary's interest in the income shall thereafter be proportionately reduced and such payments out of principal shall be charged against the share of such beneficiary in the distribution of principal hereinafter provided for.

4. The principal of the Trusts and any undistributed income therefrom shall be distributed to the beneficiaries

thereof at the time the youngest child of the Grantors shall have attained the age of 25 years.

5. In the event that any of the Grantors' said children shall die during the term of this trust, leaving issue surviving, then the issue of such child shall take the share of the father or mother, as the case may be, both of income and/or principal of the trust estate when such income and/or principal shall be distributable under the terms of this agreement. Provided that said issue shall take per capita and not per stirpes, should the deaths of all of the children of the Grantors take place before the termination of this Trust and provided, further, that should any of the said children of the Grantors die before the termination of this Trust and leave no issue surviving them, the share of such deceased child shall, subject to the provisions hereinbefore made in the event of the death of all of said children before the termination of this Trust, be equally divided among the survivors of said children or their issue per stirpes.

6. During the minority of any beneficiary hereunder, payment of income for his or her benefit may be made to the parent, guardian or other person having the care and custody of such minor beneficiary or the same may be expended by the Trustee for such minor beneficiary's benefit or may be paid to such minor beneficiary or may be made in such other manner as the Trustee in the exercise of its judgment believes will be for the best interests of such beneficiary. The receipt of any beneficiary, even though a minor, or of any person to whom amounts are paid for any beneficiary's benefit shall be a full discharge and acquittance to the Trustee for the amount so disbursed.

7. These Trusts shall be irrevocable for a period of 10 years and 30 days from the date hereof, provided that upon the death of both of the grantors, within said period

of time, the Trust shall become irrevocable without any limit or qualification as to time, except for the provisions as to termination thereof. Provided, further, that upon the expiration of said period of 10 years and 30 days, this Trust shall be revocable and amendable by the joint action of the grantors.

8. The Trustee shall have complete custody and control of the trust property and all additions thereto with power to receive, hold, manage, convert, sell, assign, transfer, mortgage, pledge, lease, alter, exchange, invest and reinvest and in any other way deal with the trust property as it in its sole discretion shall deem to be to the best interest of the trust estate. By way of illustration and not of limitation of the Trustee's powers, the Grantors authorize the Trustee:

a. To invest and reinvest the trust funds in such securities, stocks, bonds, notes, debentures, mortgages or other securities, properties or interests of any nature whatsoever, real or personal, as the Trustee shall deem to be the best interest of the trust and the beneficiaries hereof regardless of any statutes or rules of court, now or hereafter tending to limit investments that may be made by fiduciaries;

b. To determine what expenses shall be charged against principal and what against income;

c. To compromise, arbitrate or otherwise adjust claims in favor of or against the trust estate on such terms which in the judgment of the Trustee seem desirable;

d. To receive all dividends, income, rents, profits, rights and all property of every nature and description due to trust estate;

e. To execute all deeds, mortgages, contracts, leases, bills of sale, assignments, options, notes, proxies,

consents, waivers and all other instruments in writing necessary or advisable in the administration of the trust;

f. To cause the securities which shall from time to time constitute the trust estate or any part thereof to be registered in the name of the Trustee or in the name of a nominee or to take and keep them unregistered and in such condition as they will pass by delivery;

g. To make advances or to borrow money from its own banking department or from any other person, firm or corporation upon such terms and conditions as the Trustee may deem necessary or proper for the improvement, protection or preservation of the trust estate or to carry out the purposes of this trust. The Trustee shall have a lien upon the trust estate for the repayment of any advances and any interest thereon and may issue promissory notes and secure the repayment of any sum so borrowed by mortgaging or pledging any or all of the trust;

h. The Trustee may employ such agents and counsel as it may deem necessary for the proper administration of the trust and pay them such compensation as they deem just.

9. The Trustee shall submit statements of Receipts and Disbursements on regular disbursement dates to the Grantors or to the beneficiary or beneficiaries then entitled to income under the provisions of this agreement.

10. The Trustee shall be paid a reasonable compensation as may be agreed upon between it and the Grantors from time to time. Such compensation shall be no greater than that which it charges others for similar services.

11. No purchaser at any sale made by the Trustee shall be bound to inquire into the expediency, propriety,

validity or necessity of such sale or to see to, or be liable for, the application of the purchase moneys arising therefrom.

12. Additional property may be brought within the terms of this Agreement by transferring, assigning and conveying the same to the Trustee and by annexing hereto additional exhibits setting forth a concise description of the same.

13. This instrument is composed of six (6) pages exclusive of acknowledgments and schedules. Each of the copies shall be considered as an original, but all or more than one of said copies together shall be considered as constituting a single instrument.

IN WITNESS WHEREOF, the parties hereto have set their hands on the day and year first above written.

/s/ F. PAUL DUFFY

/s/ VIRGINIA H. DUFFY
GRANTORS

WITNESS:
/s/ DOROTHY C. STOLL

THE PROVIDENT BANK
By /s/ JULIUS W. REIF
Vice President
& Trust Officer

By /s/ ROBERT BROCKMAN
Trust Officer

STATE OF OHIO)
) SS:
COUNTY OF HAMILTON)

On this 26th day of February, 1963, before me personally came F. PAUL DUFFY and VIRGINIA H. DUFFY, to me known and known to me to be the individuals described in and who executed the foregoing instrument, and they acknowledged to me that they executed the same.

/s/ DOROTHY C. STOLL
Notary Public
Hamilton County
State of Ohio

My Commission Expires June 24, 1967

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No. 73-1185

Supreme Court, U. S.
FILED
MAY 22 1974

In the Supreme Court of the United States

OCTOBER TERM, 1973

F. PAUL DUFFY AND VIRGINIA H. DUFFY, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

ROBERT H. BORK,
Solicitor General.
Department of Justice,
Washington, D.C. 20530.

In the Supreme Court of the United States

OCTOBER TERM, 1973

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F. PAUL DUFFY AND VIRGINIA H. DUFFY, PETITIONERS

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

Petitioners seek review of the decision of the court of appeals holding that they were taxable upon trust income under Section 677(a)(2) of the Internal Revenue Code of 1954. That provision imposes tax upon the grantor (settlor) of a trust for all trust income that is or may be held or accumulated for future distributuion to the grantor, in the discretion of the grantor or a nonadverse party.[1]

In 1963, petitioners established trusts for the benefit of each of their four children which could have been revoked or amended by petitioners at any time after ten years and thirty days from their creation (Pet. App.

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[1]Although petitioners argued below that the bank-trustee was an adverse party, they have now abandoned this contention. See Section 672(a) for the definition of "adverse party."

39-42). Under the trust instrument, the trustee-bank had sole discretion to accumulate the income or to distribute it for the "education, maintenance or welfare" of each beneficiary (Pet. App. 40). When each child attained the age of twenty-one, the accumulated income was to be added to the trust corpus and thereafter the accruing income was to be distributed to each child (*ibid.*). The trusts were to terminate and all the principal and undistributed income were to be distributed to the children when the youngest child reached twenty-five (Pet. App. 40-41). However, if petitioners revoked the trusts after the ten-year and thirty day term, they could have received the accumulated income of the trust.

Because the trusts could have been revoked by petitioners and the accumulated income might have been distributed to them, Section 677(a)(2) by its terms applies to this case. Petitioners, however, contend (Pet. 9-12) that they qualify under the exception set forth in the last sentence of Section 677(a). That exception provides that:

> This subsection shall not apply to a power the exercise of which can only affect the beneficial enjoyment of the income for a period commencing after the expiration of a period such that the grantor would not be treated as the owner under section 673 if the power were a reversionary interest; but the grantor may be treated as the owner after the expiration of the period unless the power is relinquished.

Petitioners submit that because they could not revoke the trust within ten years of its creation and would not be treated as the owners of the trust under Sec-

tion 673 if the power were a reversionary interest, they are not chargeable with the income of the trust under Section 677(a)(2).

The short answer to this contention is that the above-quoted exception clause applies to a grantor who has a power only over trust income accruing after the expiration of the ten-year period. Under such circumstances, the grantor will not be taxable on trust income accruing prior to the expiration of that period. As the court of appeals correctly recognized (Pet. App. 22-27), however, the exception does not cover this case, where the grantors' power was over trust income earned within the ten-year period.

This interpretation is supported by both the legislative history of the provision and the Treasury Regulations which specifically provide that the exception clause does not exempt a grantor from tax on trust income earned within the ten-year period, if the grantor may receive the accumulated income after the expiration of the period. See S. Rep. No. 1622, 83d Cong., 2d Sess., p. 371; Treasury Regulations, Section 1.677(a)-1(f). To the extent there are other decided cases on this point, they are in agreement with the decision below. See *Humphrey* v. *United States*, 245 F. Supp. 49 (D. Kan.); *Humphrey* v. *Commissioner*, 39 T.C. 199. See Rev. Rul. 57-363, 1957-2 Cum. Bull. 326.

For the reasons stated, it is respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

MARCH 1974.